COMMISSION ON STATE TAX AND FINANCING POLICY

Legislative Services Agency
200 West Washington Street, Suite 301
Indianapolis, Indiana 46204-2789
Tel: (317) 232-9588 Fax: (317) 232-2554

MEETING MINUTES[1]

Meeting Date: October 12, 1999
Meeting Time: 10:00 A.M.
Meeting Place: State House, 200 W. Washington St., Room 431
Meeting City: Indianapolis, Indiana
Meeting Number: 2

Members Present: Sen. Lawrence Borst, Chair; Sen. Thomas Wyss; Sen. Vi Simpson; Rep. Vern Tincher; Rep. Lawrence Buell.

Members Absent: None.

Senator Borst called the meeting to order at 10:10 am. He introduced the members present and informed everyone that the meeting would be on the Financial Institutions Tax (FIT).

Chairperson Borst noted that the language that would provide for apportioning income for resident institutions was being discussed on the final day of the 1999 legislative session. He added that this proposal was tied to other issues. Senator Borst discussed the history of the tax, which was adopted in 1989 and first applied in 1990. He added that the tax change was discussed throughout the 1980s. The new tax put Indiana in the forefront of taxation, but Congress has since enacted legislation that allows banks more freedom to move and expand and that this has made the tax onerous to resident institutions compared to nonresidents.

Senator Borst said that he wanted to hear from the Department of State Revenue and the industry with regard to the issues. Since the Senate passed the apportionment bill (SB 189-1999) he added that the industry needs to work with the Governor's office and House members. He noted that the 2000 session is a short session probably reserved for emergency matters. He then introduced Ken Miller, Administrator of the Department of State Revenue.

Department of Revenue

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[1] Exhibits and other materials referenced in these minutes can be inspected and copied in the Legislative Information Center in Room 230 of the State House in Indianapolis, Indiana. Requests for copies may be mailed to the Legislative Information Center, Legislative Services Agency, 200 West Washington Street, Indianapolis, IN 46204-2789. A fee of $0.15 per page and mailing costs will be charged for copies. These minutes are also available on the Internet at the General Assembly homepage. The URL address of the General Assembly homepage is http://www.ai.org/legislative/. No fee is charged for viewing, downloading, or printing minutes from the Internet.

Mr. Miller told the Commission that the 1991 FIT revenue was $65 M and it increased each year reaching a peak in 1996 at $122 M. The revenue has dropped since 1996. He anticipates additional decreases. He explained that these decreases could be due to lower profits because of merger costs and the build up of refund balances from overpayments. He then reviewed the lawsuits that have been filed. The most recent one is a suit by Bank One challenging various aspects of the tax and the Department of State Revenue's interpretation of the unitary business provisions of the law. Mr. Miller also mentioned the Fort Wayne National case, which upheld the inclusion of interest on federal and local obligations in measuring the tax liability.

Mr. Miller said that the Department of State Revenue has now assigned auditors to credit card companies doing business in Indiana, but that do not have a physical presence in Indiana. This is the last phase of enforcement of the tax.

Mr. Miller introduced Jack Lewis, Financial Institutions Tax examiner for the Department. Mr. Lewis explained that the approach used to tax resident institutions was to prevent "no-where" income by applying the tax to 100% of the income of the institutions and giving a credit for actual taxes paid to other states.

Senator Borst asked about S corporation elections by financial institutions. Mr. Lewis answered that an S corporation can have up to 75 shareholders but can not use the reserve method of accounting. Mr. Miller added that the Department has not seen any amended returns so far.

Senator Borst asked how the Department audits the prices charged within a bank holding company to prevent what is known as transfer pricing. He explained that an out of state parent bank can charge an Indiana affiliate for services at a price that may shift profits away from the Indiana bank. Mr. Lewis responded that pricing is regulated at the federal level and the Department does not specifically look at it. He noted that under the combined income approach in the current law, all income (including that of the nonresident charging the high fee) is included and then the combined income is apportioned based on receipts.

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Chairperson Borst then asked the Legislative Services Agency to review its background material that had been provided to the Commission by Michael Landwer and Diane Powers. Mr. Landwer noted that the Indiana approach was at the forefront in 1989 and that Ms. Sandra McCray advised the 1988 Commission on the best features of a franchise tax for financial institutions. He added that using customer location versus physical presence has been adopted in several states. He informed the Commission that a Tennessee trial court had upheld the use of economic presence for a financial institutions tax. (See the LSA background paper for more information.)

Senator Borst asked when the Bank One suit was filed and Mr. Landwer said 1997. Mr. Miller of the Department of State Revenue noted that it is was commenced at the Department level in 1996.

Apportionment of Income

Chairperson Borst then introduced Senator Kenley who authored SB 189-1999. Senator Kenley told the Commission that he thought it was a fairness issue for resident institutions. He discussed audits and the need to look into the transfer pricing issue. He added that a loss of a bank charter usually means the loss of local decision-making as well. Local businesses have better opportunities for financing with local decision-making. Senator Kenley questioned whether bank mergers were a significant factor in lost revenue.

Senator Borst commented on the decrease in service at his bank, which is now a branch in a large bank system. Senator Borst also noted that it makes sense to attract banks to Indiana but that banks need to pay taxes. He added that the HB 2054-1999 introduced by Representative Crosby would eliminate interest on federal obligations and this is attractive to some financial institutions.

Testimony

Senator Borst then introduced Kerry Spradlin of the Indiana Bankers Association. Ms. Spradlin reviewed two studies that have been commissioned by the Association. One shows the positive impact banks have on a local and state economy. She added that banks and their employees participate in community activities and even though bank employees comprise only 2.5% of the population they comprise 20% of the board members of not-for-profit corporations. The second study shows that Indiana has a higher tax burden than Michigan or Illinois. The study used two hypothetical banks and compared the tax burdens of the surrounding states. (See the copies of these studies for more information.) She added that Citizens' Bank of Evansville has moved to Michigan and that Old National Bank of Terre Haute is doing the analysis on whether to move. Some Indiana banks are hopeful that the SB 189-1999 language would be adopted on organizational day in November and are waiting to make any final decisions.

Senator Borst introduced Tom Williams who represents the Federal Home Loan Bank (FHLB) of Indianapolis. Mr. Williams explained that the FHLB is a banker's bank with $28B in assets and is owned only by banks chartered in Indiana or Michigan and that if an Indiana bank moves its charter from Indiana to another state besides Michigan, FHLB becomes smaller. He is concerned that the Indianapolis office might be merged into the Chicago or Cincinnati office if too many charters move. He informed the Commission that the FHLB supports 300,000 mortgages and federal legislation is being considered that would broaden its powers to include commercial lending for agriculture and small business. He said that Illinois and Michigan have been updating their financial institutions laws to make their states more attractive. He agreed that decision-making follows the charter.

Senator Wyss asked Ms. Spradlin why Bank One and National City stay in Ohio since their taxes are even higher than Indiana's. She said that apportionment is one factor but the Indiana rate is also high. Senator Wyss asked how much impact is there to a bank. Ms. Spradlin said that it was $1.6 M annually for Citizens of Evansville and $300,000 for Old National.

Chairperson Borst asked Mr. Thomas Ristine of Ice, Miller, Donadio, and Ryan if he had any comments. Mr. Ristine said that the banks he works with want to see the change to apportionment for resident financial institutions effective January 1, 1999.

Senator Borst asked about S corporation elections and Mr. Ristine responded that he has seen less than 65 in Indiana but it is a prevalent technique in other states where he has seen as many as 50-60. Mr. Ristine said he supported the Senate passed version of SB 189-1999.

Chairperson Borst then introduced Mr. Larry Lentych, Chief Financial Officer, 1st Source Bank. Mr. Lentych informed the Commission that 1st Source was established in Indiana in 1863 in South Bend. They now have 50 locations in 12 counties in Indiana and Michigan. They do loans and leasing and also have 15 specialty offices in Indiana, Michigan and Kentucky. They have 1040 employees. He emphasized that they are at a tax disadvantage to nonresident institutions. He testified that it is a $1 M tax difference. He owes a duty to shareholders to provide the best return. It is fairly easy to move the charter, and there are no disadvantages for his bank since they already have eight Michigan locations. He said that the taxation of federal obligations in Indiana is also onerous. He added that he did not want to change the charter. He said the shareholders are delaying a decision to see if legislation is passed effective January 1, 1999.

In response to Senator Borst, Mr. Lentych stated that states may require some physical presence of a principal office and this would result in employees being moved from Indiana.

Chairperson Borst then introduced Mr. Michael Carty, Senior Vice President and Chief Financial Officer, Terre Haute First National Bank. He informed the Commission that their charter was established in 1834. He added that a charter move to Illinois would save $300,000 and that they already have a branch location in Illinois. A charter move by banks will have a long term impact. It moves decision-making out of state.

Senator Borst commented that the state appropriates $4-5 M per year to keep or attract industries.

Senator Wyss added that Indiana should try to keep charters here.

Senator Borst introduced Charles Phillips, Administrator of the Department of Financial Institutions. Mr. Phillips indicated that banks have put together a task force to recommend that the apportionment factor be applied to resident banks. The task force is hoping to get the Commission's support for November passage of the language. He said that while it may be a paper move to accomplish a change in charter that, in the long term, it is a charter move, then a capital move, then jobs, and then philanthropy in the community. He said that many institutions moved from Georgia to North Carolina as a result of more favorable laws. Alabama is also an attractive state. He added that certain economic information about a state is reported based on bank charters and charter moves will make Indiana look "poorer". He said that the Governor and Lt. Governor favor keeping charters in Indiana. He said that the number one concern of his in banking is the number of new banks that are riding the economy and have not seen the down side of a cycle.

Exemption of Interest from U.S. Treasury Obligations

Representative Crosby then testified on HB 2054-1999. She explained that the Bill would eliminate from financial institutions taxation the interest received from United States Treasury obligations. She emphasized that banks are important to a community and that the Community Bankers Association supported the proposal.

Testimony

Chairperson Borst then introduced Mr. Joseph DeHaven, President of the Community Bankers Association. He provided a handout that compared taxation in Illinois and Michigan. He explained that Ohio and Kentucky were not included because they impose asset based taxes. He said that nonresident institutions house federal obligations out of state. He indicated a total exemption would reduce taxes by $56 M and would bring Indiana in line with Illinois and Michigan. Mr. Doug Born, a CPA with George S. Olive, LLP, spoke about the impact and indicated that $56 M represented 5-7% of net income and, therefore, is a factor in a competitive market.

Senator Simpson asked if the proposal was broader than interest on federal obligations and Mr. DeHaven said the proposal includes both local and federal obligations.

Chairperson Borst introduced Mr. Bill Harrod, President and CEO of the Harrison County Bank. He said that the bank is a $90 M bank. The decision-making is local. He stated that eliminating the interest on federal obligations would mean about $245,000 over five years. He emphasized that it is a fairness issue, especially with internet banking to happen soon. He added that keeping charters local will benefit the community.

Senator Borst briefly mentioned that the National Conference on State Legislatures is studying the issue of internet taxation. He informed the Commission that there is currently a moratorium on new taxes and that recommendations are due next spring.

Senator Wyss added that community programs in Fort Wayne have suffered. Mr. DeHaven agreed that charter moves will affect community programs and that while the impact is significant it is a fair policy. He asked that the Commission support lowering the Financial Institutions Tax burden.

Senator Borst noted that the community and state bankers agree on the apportionment issue and will be working on other issues. He then introduced Mr. William Salin, Salin Bank and Trust Company. Mr. Salin said he concurred in much of what has been said already. He added that Indiana needs to keep bank charters. He noted that investment assets of banks are located in the charter state. He said the Salin bank would not move its charter. He said that Indiana had 400-500 charters in 1978 and now there are 134. Senator Borst added that Indiana should try to attract charters.

Senator Borst then introduced Mr. Michael Alley, President and CEO, Fifth Third Bank Indiana. Mr. Alley said that he supports apportionment for residents. He explained the corporate structure of Fifth Third and that Fifth Third would like to keep its Indiana charter. However, after acquiring Peoples and CNB Bancshares, an analysis showed that Fifth Third could save $2 M annually if it chartered in Michigan instead, which could be named Fifth Third Midwest. Senator Borst said it would be wise to let all legislators know the reasoning by Fifth Third.

Chairperson Borst then introduced Mr. Greg Schenkel, who represents Bank One. He told the Commission that Bank One is now located in 34 states and has 8,000 Indiana employees. He said because the Indiana rate is comparatively high and there is not an apportionment factor for resident banks, it makes Indiana less competitive. He added banks have lots of factors to consider when chartering. He indicated that Bank One has one Indiana charter but does not charter its leasing and consumer finance operations in Indiana.

Chairperson Borst closed by thanking all the individuals who testified. He said that he hoped there would be some comprehensive proposals to emerge.

The meeting was adjourned at 12:15p.m.